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COSTA RICA
POLICY TOOLS FOR RURAL FINANCE

COSTA RICA:
ISSUES IN BANK DEPOSIT MOBILIZATION

by

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I. INTRODUCTION

Since the nationalization of the Costa Rican Banking System in 1948, the Central Bank has played a major role not only in the supervision of the state-owned commercial banks, but also in their day to day administration. The Central Bank had traditionally defined at what price the financial transactions would take place and designed detailed annual credit programs to control the distribution of credit among the various sectors of the economy. Although the banks are nominally autonomous institutions, they must conform to Government regulations in the purchase of inputs (for example, computers, salary levels,). In many respects, the state-owned financial institutions have been managed as public utilities, with virtually no institutional autonomy.

In recent years, however, this control has been loosened, as a result of government policies directed towards liberalization of financial markets in Costa Rica. The banks have obtained greater operational autonomy with regard to setting interest-rate structures and in the distribution of credit. Because of this greater freedom, competition among state owned-banks and private financial institutions has increased significantly. The need to compete has highlighted important administrative rigidities within the state-owned commercial banks, which will require a serious effort in organizational transformation.

The weaknesses in their administrative structure are most evident in the area of deposit mobilization. These banks have had difficulties recovering real growth in deposit mobilization following a period of financial instability which afflicted the Costa Rican economy in the early 1980s. The lack of institutional autonomy and clearly defined objectives has hampered their ability to respond to this crisis.

In 1987, following a long transition towards financial liberalization, the banks were freed from interest-rate and selective-credit controls. However, this new found freedom was short-lived as credit ceilings and a gentleman's agreement on interest rates were reimposed on state-controlled banks at the beginning of 1988. This action on the part of the Costa Rican Government resulted from an unanticipated growth in inflation and overvaluation of the colón. Another reason was competition for savings in the financial markets. Although there is an important process of institutional transformation of state-owned commercial banking in Costa Rica, the evolution to greater institutional autonomy and greater competition has been slow.

The objective of this paper is to highlight the major issues and problems in the area of deposit mobilization within the state-owned commercial banks. The major conclusions are derived from an analysis focused primarily on the Banco Nacional with only a cursory view of Banco de Costa Rica. Although not all of the statements and conclusions drawn may apply to all state-owned banks, I have tried to contrast experiences when possible. In the second section, internal organizational issues surrounding deposit mobilization will be analyzed, while in the third, specific types of instruments and strategies will be presented. In the fourth section, the impact of greater competition for domestic savings and the responses by state-owned banks will be considered. In the fifth section, data on deposit mobilization will be presented, in order to substantiate some of the conclusions drawn in the paper. The final section will provide a summary of the major findings.

II. GENERAL ORGANIZATION

Implicit in the present organizational structure and philosophy of the state-owned banks is the view that deposit mobilization is not an independent service in itself. Its importance is related to supplying necessary inputs for credit services. Their organizational structure does not include a central office or department responsible for developing and implementing an institutional strategy in this area, nor are there clear lines of responsibility.

The Finance Department within the Banco Nacional and the Planning Department in the Banco de Costa Rica have very recently been made responsible for setting branch-level targets for deposit mobilization and to carry out some degree of ex-post evaluation. However, these targets are considered more as informal guidelines rather than strict operational objectives.

Their role is centered primarily on improving the efficiency of liquidity management.

In general, there is an excessive degree of administrative centralization within the state-owned commercial banks. In the area of deposit mobilization this centralization is complete. Branch offices are given no flexibility whatsoever to negotiate interest rates with depositors. Furthermore, they enjoy no independence in the use of these funds, despite having mobilized them at the local level. The degree of administrative centralization is somewhat less severe in the Banco de Costa Rica than that observed in the Banco Nacional.

The internal operations of state-owned banks have unmistakably been molded by many years of detailed selective credit controls (<u>topes de cartera</u>). All resources mobilized are placed at the disposition of the main office, which must ration and distribute them in accordance with pre-established credit limits. Authority to extend credit beyond these limits at the branch level had to be sought from the main office and ultimately from the Central Bank. These restrictions effectively eliminated the single most important incentive for deposit mobilization on the part of branch level offices. When confronted with an excess demand for credit, for example, branch managers cannot rely on liability management, since they have no independence with regard to the administration of these funds.

The Finance Committee within the Banco Nacional is responsible for financial management. Although decisions on interest-rate policy on loans are reserved for the Board of Directors, this Committee utilizes interest rates on time deposits as one of their primary policy instruments with which to resolve short-term liquidity problems. However, the focus of this Committee in so far as it relates to deposit mobilization is extremely short-term, and almost exclusively concerned with time deposits. In the case of the Banco de Costa Rica, interest-rate policies are centralized in the hands of the General Manager, together with a team of advisors.

As pointed out above, there does not exist a deposit mobilization department in either of the banks and, as a result, the administrative structure as it relates to deposit mobilization is highly fragmented. There is a savings mobilization department in the central office at the Banco Nacional and its responsibilities include centralized accounting on time deposits for the entire bank. However, with regard to other liability instruments, its responsibility is limited only to the branch which is located in the same building.

As a result, branch-level offices do not maintain detailed records with regard to the volume and number of time deposits. Detailed branch-level information does not exist and therefore an evaluation of their relative performance is impossible at the present time. The statistics of many smaller branch offices are consolidated with the accounting information of larger offices.

There are no employee bonuses or incentive programs in place at either bank which could help motivate a more aggressive effort in deposit mobilization. On the contrary, both the absolute quantitative limits on total credit (programa crediticio) and lack of independence in the disposition of local deposits mobilized may in fact provide a strong disincentive. In contrast, the Banco de Costa Rica has implemented a system of Account Executives, creating a more comprehensive approach to marketing of financial services. This marketing strategy is targeted towards very large public- and private-sector clients.

During the last quarter of 1987, in an effort to improve the efficiency in liquidity management of Central Government finances and sterilize some excess liquidity in the market, the Central Bank issued a directive prohibiting autonomous public-sector institutions from maintaining deposits outside of the Central Bank. The state-owned banks faced the prospect of loosing all deposits mobilized from various public institutions. In the case of Banco Nacional, these deposits represented a significant proportion of total deposits. Initially, this directive led to a significant transfer of funds out of the commercial banks and to a significant rise in the market rate of interest, as the banks competed for deposits from the public with which to replace these lost resources. Banco de Costa Rica raised its interest rates on six month time deposits from 21 to 25 percent.

Because of resistance on the part of branch managers in Banco de Costa Rica to this more aggressive interest rate policy, a mechanism of transfer pricing has been instituted. Branches from which transfers are made are compensated only for the interest costs incurred. Such a formal mechanism does not yet exist in Banco Nacional. However, transfer pricing is of limited use, because in neither institution is there a functional cost accounting system which would allow an effective evaluation of relative branch profitability or operational efficiency.

The Banco Nacional has 128 offices distributed throughout the country with which to reach the rural population. There are: 22 branch offices, 58 agencies, and 48 auxiliary offices. This large number of offices clearly gives this bank an important competitive advantage in deposit mobilization in the rural area. The Banco de Costa Rica, which has traditionally served the urban industrial and commercial clientele, has less of a rural presence. However, this institution has been fairly aggressive in opening new offices. In 1987 one new branch office and 10 agencies were opened, for a total of 25 branch offices and 19 agencies.

The main obstacles facing these banks with regard to deposit mobilization are lack of institutional and individual incentives. Although the institutional centralization is a function of past intervention on the part of the Central Bank, the relaxation of these controls will not automatically lead to decentralization. Decision making continues to be highly centralized as a result of their institutional culture. There does appear to be awareness of the limitations imposed by excessive centralization within both institutions; however, change can be expected to be quite slow.

III. LIABILITY INSTRUMENTS

Passbook Savings Accounts

Given the wide distribution of offices throughout the countryside, the Banco Nacional has a very good base from which to mobilize relatively low cost (financial) funds. The importance of transactions costs in the demand for passbook savings accounts has been recognized, and separate cashiers are generally provided in all offices. The lack of price competition among state owned banks with respect to passbook savings accounts is evident.

The competitive strategies followed by the two major state-owned banks have been focused on differentiating their product with the promotion of the computerized networking of offices in the Central Valley. Each institution offers their clientele the ability to withdraw funds from a number of different locations. This strategy is more coherent for Banco de Costa Rica as a majority of its offices are located there. For the vast majority of depositors of Banco Nacional this service is inconsequential.

The Banco de Costa Rica has instituted a children's passbook savings program that pays 2 percentage points above the regular passbook accounts (10 versus 8 percent). Ostensibly, the objective of this program is to teach the benefits of savings to the young as well as to attempt to create client loyalty of these present and future Banco de Costa Rica clients. The program is relatively new, and given the long-term nature of its objectives, evaluation of its benefits is difficult.

The decision not to compete with respect to interest rates on passbook accounts appears to be a logical decision, since price discrimination among depositors is not possible as in the case of time deposits. However, consistently negative real rates of interest on these accounts may in fact be an important limitation for real growth. Apparently, in recent years the aggressive strategy of deposit mobilization on the part of individual credit unions has had an important impact on some branches of the state-owned banks. Smaller institutions with lower transactions costs for depositors and higher rates of interest have constituted a competitive threat with regard to these instruments.

Another important factor which may limit the interest in mobilizing these deposits are high transactions costs. In branches outside of the Central Valley, these accounts are not computerized and all interest calculations must be carried out manually. This obviously places a fairly heavy burden on bank employees, and may impose significant transactions costs on depositors.

Time Deposits

As indicated above, both Banks have been very aggressive in the use of interest rates as the major component of their competitive strategy in the mobilization of time deposits. In the case of Banco Nacional, one of the problems mentioned by the officials interviewed was that these deposits are highly concentrated in the hands of a few government institutions. There has been some concern expressed within both institutions that the overly aggressive use of interest rates, not only creates instability with the transfer of "hot money," but may also hurts their relations with preferred clients. Interest rates are raised frequently to resolve short-term problems of liquidity, and then reduced just as frequently once the problem subsides.

Checking Accounts

As in the case of passbook savings accounts, checking accounts are managed in a decentralized fashion. Since these deposits are not computerized throughout all branches, confirmation of balances must be made by telephone, raising transactions costs to their clients. In both banks a minimum of 20,000 colones is required to open a checking account. However, no minimum average balance must be maintained and no monthly charges are levied. Because of the lack of a functional cost accounting system, the true operational cost of servicing these accounts is not known. However, without doubt most of their checking accounts are not profitable. Both institutions have recognized the importance of an improved cost accounting system and are taking steps towards its implementation. A revision of the charges levied and minimum balance requirements is needed.

Both institutions have recently begun to compete quite aggressively with Automatic Teller Machines (ATM) and although they are very successful in reducing transactions costs for clients, their economic rationale is still unclear. In addition to problems of educating and convincing clients to use them (a problem which has plagued banks in the U.S. for a long time), a review of fees charged for their uses is in order. With a flat yearly charge to checking account clients, these machines are being used to a large extent to consult balances, a service for which the clients would not wait in the long lines at the bank.

It is frequently argued that the monopoly enjoyed by the state-owned commercial banks with respect to checking accounts is necessary for their financial survival. However, it is doubtful that, if given the opportunity, private banks would attempt to compete for the same segment of the market. These banks would most likely attempt to capture the very large institutional accounts, for which the commercial banks are already facing competition from the brokerage houses in the National Stock Exchange. However, this pressure has been relieved to some degree by the financial crisis at the end of 1987 and beginning of 1988.

IV. COMPETITION IN DEPOSIT MOBILIZATION

Despite the nominal monopoly on checking accounts, the state-owned banks have been faced with competition on the part of investment funds promoted by brokerage houses in the National Stock Exchange. These funds offer their clients short-term (one week) highly liquid investments which pay very attractive rates of interest. So far, only Banco de Costa Rica has confronted this competition head on, and has devised a mechanism with which to pay interest on checking account balances. Likewise, the intense competition for time deposits has induced public-sector bankers to devise imaginative ways of reducing reserve requirements, as well as increasing the tax free rate of return to depositors.

In spite of the presumed monopoly in mobilizing short-term deposits, the state-owned banks have faced fairly stiff competition from the private banks, brokerage houses, credit unions, savings and loan associations as well as from non-regulated financial intermediaries. However, as a result of the recent panic that has swept the financial markets over the past 6 to 9 months, the issue of government guarantees has become of primary importance to depositors. In recent months, the public-sector banks have taken full advantage of this crisis, playing on the fear of depositors as their main marketing tool. This crisis has reduced the competitive pressures on these institutions, and in the present financially-unstable environment they should be able to reap some economic rent from government ownership.

The cumulative effect of the bankruptcy of a few non-regulated finance companies on the fringes of the financial markets, combined with a severe monetary contraction by the Central Bank in the last quarter of 1987, set the stage for a run on deposits, bringing down one of the more respected regulated finance companies: Crediticia. The financial panic was beginning to create problems for the private banks; however, given the composition of their liabilities, which are heavily weighted with long-term loans from the U.S. Agency for International Development. This limited its severity. With advent of the failure of Crediticia, the Central Bank and National Stock Exchange injected liquidity into markets to avoid further runs.

The competitive pressure within Costa Rican financial markets has diminished significantly since the financial crisis, as the gentleman's agreement on interest rates demonstrates. The regulatory dichotomy within the Costa Rican financial markets, in which one sector enjoys unconditional government guarantees, while the other does not even have access to a lender of last resort, must be resolved. If not, the significant progress in operational efficiency and innovation observed within the public-sector banks could suffer a serious setback.

V. RECENT DEVELOPMENT IN DEPOSIT MOBILIZATION

In Chart 1 (in the appendix) the volume of total deposits mobilized by the Banco Nacional are presented on a semester basis from December 1980 to December 1987. In current prices the volume mobilized has grown from slightly over 5 billion colones at the end of 1980, to 25 billion at the end of 1987. However, in constant 1975 colones, total deposit mobilization has actually declined slightly over the period. The composition by instrument of the volume of mobilized funds is presented in Charts 2 through 5. It is interesting to note that the volume of time deposits mobilized has the most erratic behavior, reflecting the aggressive competition among the banks. Apparently, checking accounts have been the only instrument that has been able to sustain its balance over the period, in real terms.

Chart 6 presents the relative market shares among the state-owned banks with regard to total deposit mobilization. Banco Nacional has lost market share to Banco Costa Rica and Banco Anglo Costarricense, while the Banco Crédito Agrícola de Cartago has maintained its market share. Obviously, with the rapid growth in the Bolsa Nacional de Valores and private financial intermediaries, the state-owned banks have lost market share if the aggregate financial markets are considered (lack of an adequate data base precludes a more exact analysis here).

Analysis of Chart 7 through 9 indicates that the distribution of this loss in total deposit market share for the Banco Nacional is heavily concentrated in the area of checking accounts. Recent changes in accounting procedures, which reduce their reserve requirements, may have influenced the results for the last few months. Still, some erosion of their market share is evident.

Finally, Chart 8 underlines the intense competition among the various state-owned banks in time deposits. Savings accounts, on the other hand, have remained quite stable. This has reflected the lack of competitive pressure in this segment of the market. It must be reiterated that these charts on market share only reflect the relative position among the state-owned banks. They do not indicate the market share in the financial markets in the aggregate.

V. CONCLUSIONS

In general, as a result of the competitive pressures faced by the state-owned banks due to the rapid growth of private banks, finance companies and the Costa Rican Stock Exchange, institutional changes and innovations designed to improve operational efficiency have been evident. In general, the Banco de Costa Rica is somewhat more aggressive and innovative than Banco Nacional; however, its operational structure suffers from many of the same problems.

The Banco Nacional has a clear comparative advantage in deepening its rural deposit mobilization in general, and in particular with greater emphasis on passbook savings accounts. Consistently negative real rates of interest could inhibite greater growth in the volume of resources mobilized with this instrument.

The large investment in rural branch offices in the Banco Nacional makes this a natural target for future deposit mobilization efforts. However, the most important obstacle facing this institution and the Banco de Costa Rica is the lack of a coherent internal organization to facilitate ar [illegible] te an aggressive long-term strategy for deposit mobilization. There are important organizational disincentives for more aggressive deposit mobilization, and these must be eliminated in order to maximize the returns to past investments in human and physical capital. The excess degree of administrative centralization observed in both institutions can only be reduced if an effective mechanism for personnel evaluation is devised and implemented. This will require an important investment in information management.

In the aggregate, deposit mobilization on the part of the Banco Nacional has been stagnant over the past six years. The growth in resources has not kept up with the growth in inflation. In addition, the bank has lost relative market share to the other state-owned banks. The lack of competitive pressure among state owned banks is evident in passbook savings accounts. There is some attempt towards product differentiation in the area of checking accounts. This can be seen in the Banco Costa Rica, which is indirectly paying interest on these accounts. This innovation was motivated primarily through the competition generated by brokerage houses in the National Stock Exchange. However, the recent panic in financial markets may eliminate this competitive threat to the monopoly of the state-owned banks in the marketing of this instrument.

Finally, the recent events disturbing the confidence of the depositing public in private financial intermediaries has dramatically underlined the serious distortions created by the regulatory dichotomy in Costa Rican banking laws. The uneven playing field confronting the private financial institutions not only places them at a serious competitive disadvantage in mobilizing resources, but may have the unintended result of reversing of slowing the significant progress observed within the public-sector banks in the areas of operational efficiency and financial innovation. Ultimately the Costa Rican population will pay the price for the growing inefficiency of their financial markets.

NOTES:

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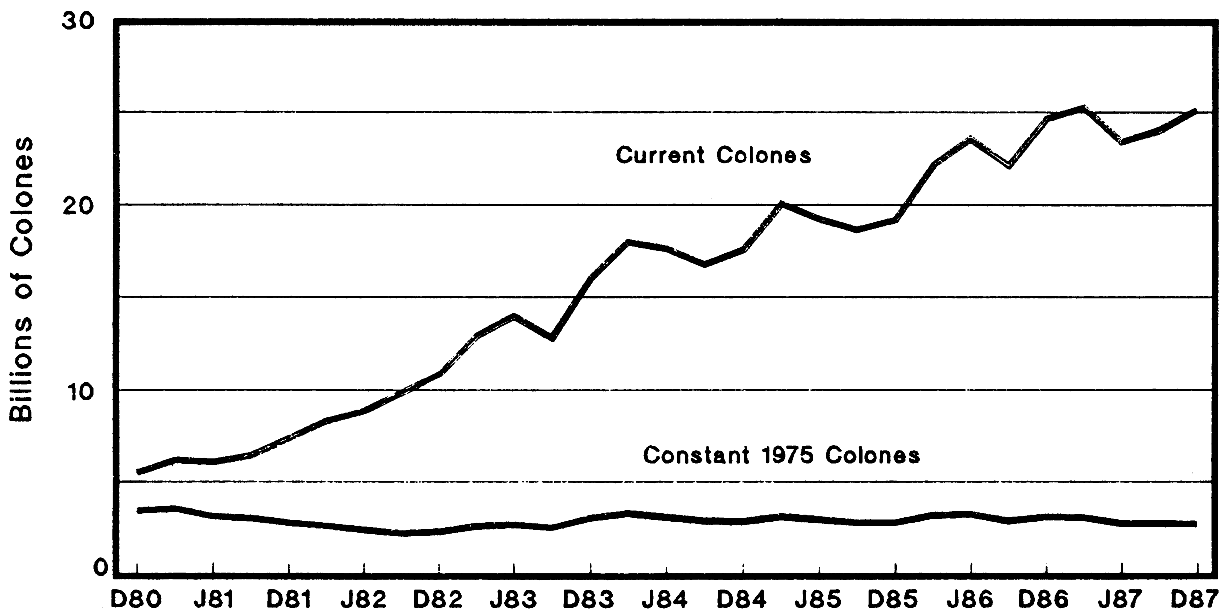
APPENDIX

Chart 1

Banco Nacional de Costa Rica

Total Deposits: Dec 80 - Dec 87



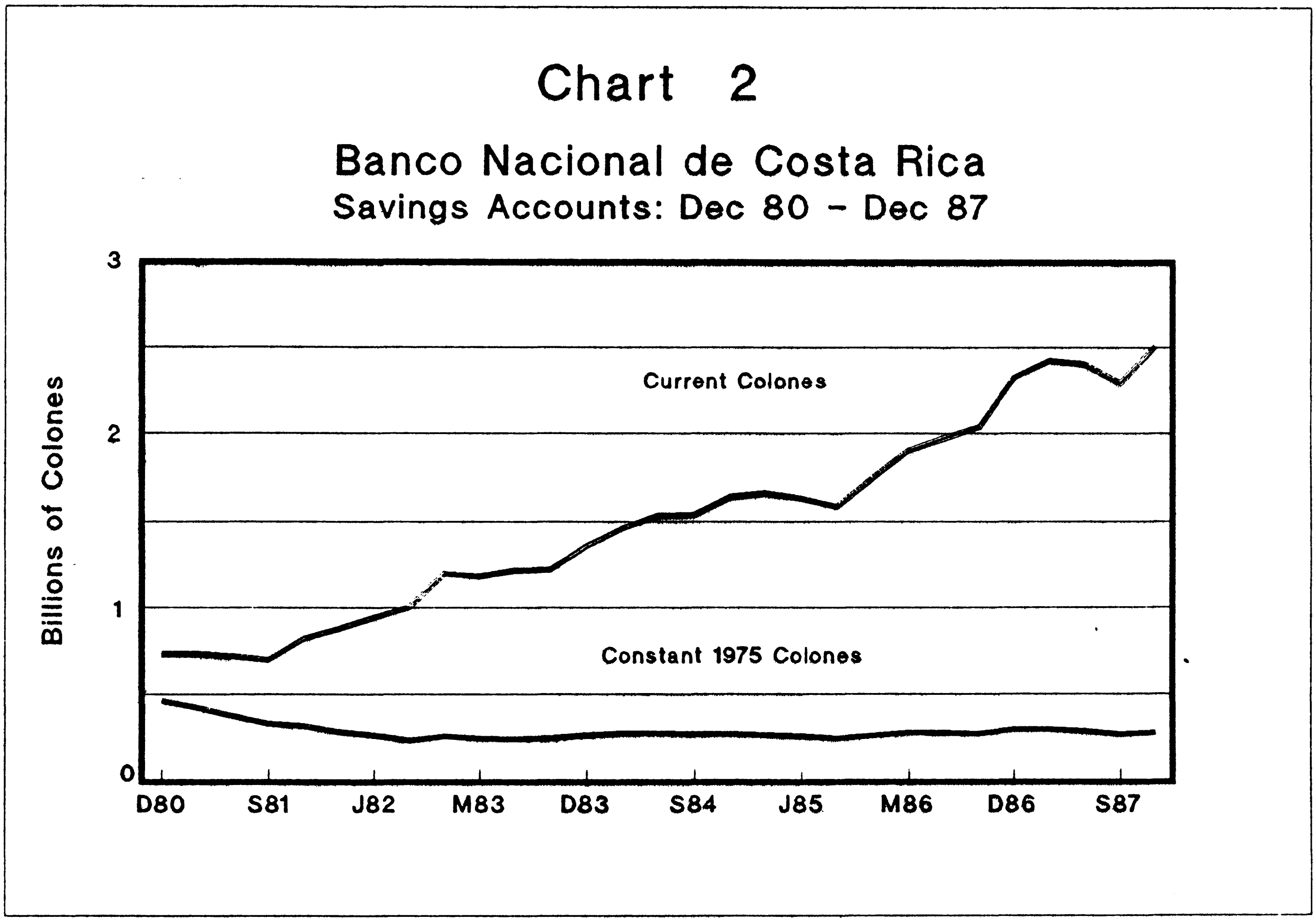


Chart 2
Banco Nacional de Costa Rica
Savings Accounts: Dec 80 - Dec 87
Billions of Colones
3
2
1
0
Current Colones
Constant 1975 Colones
D80
S81
J82
M83
D83
S84
J85
M86
D86
S87

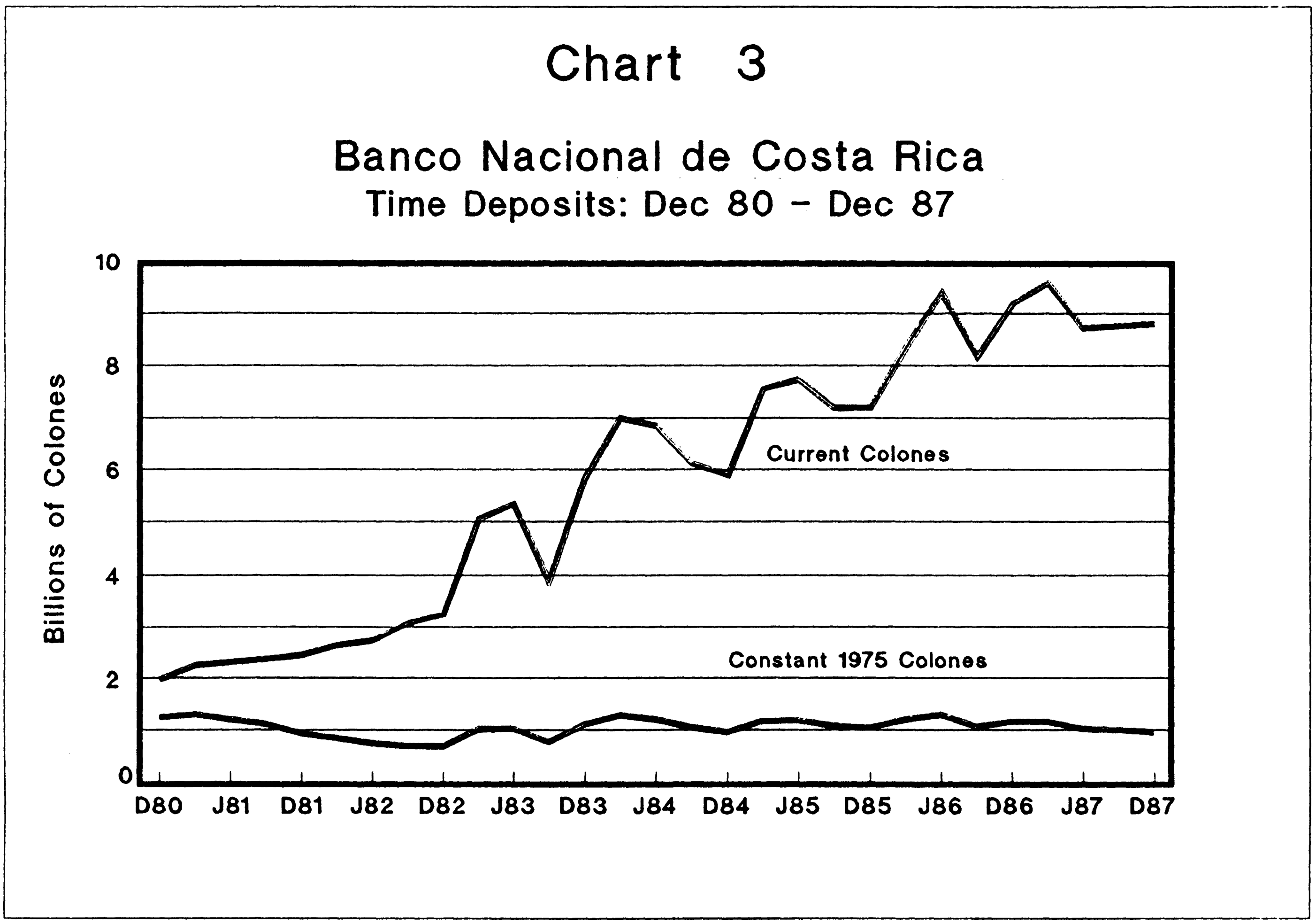
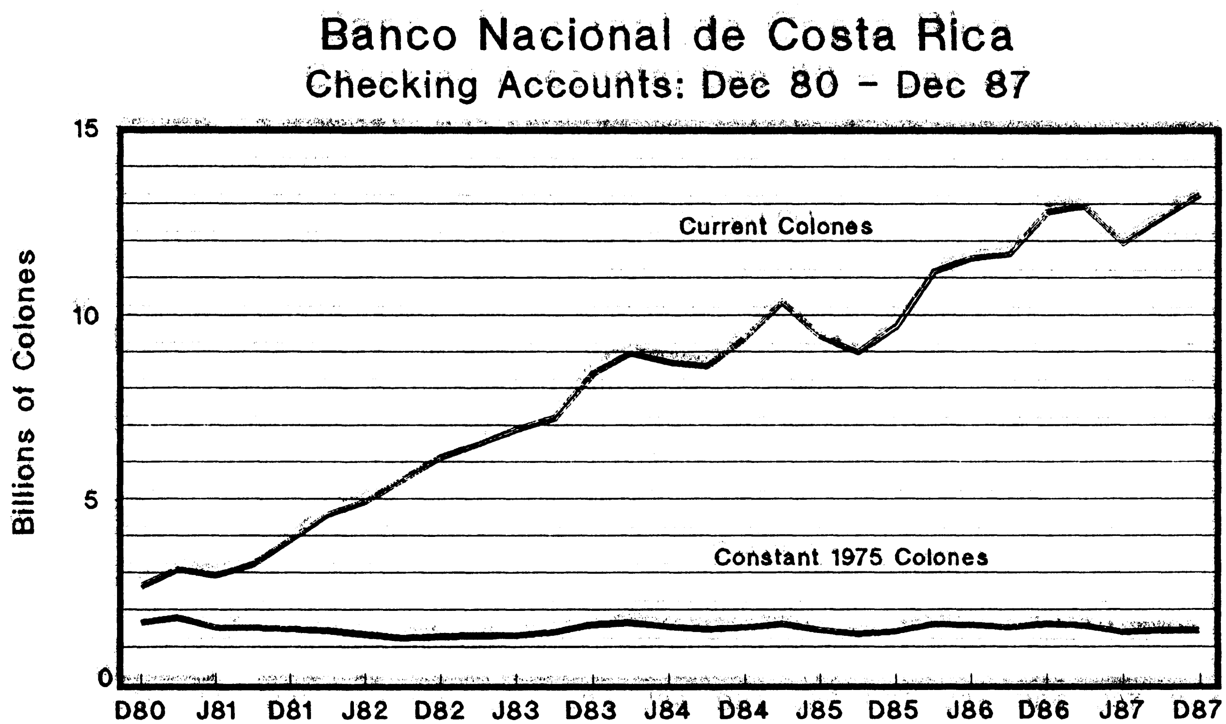


Chart 3
Banco Nacional de Costa Rica
Time Deposits: Dec 80 - Dec 87
Billions of Colones
10
8
6
4
2
0
Current Colones
Constant 1975 Colones
D80
J81
D81
J82
D82
J83
D83
J84
D84
J85
D85
J86
D86
J87
D87

Chart 4



Banco Nacional de Costa Rica
Checking Accounts: Dec 80 - Dec 87
Billions of Colones
15
10
5
0
Current Colones
Constant 1975 Colones
D80
J81
D81
J82
D82
J83
D83
J84
D84
J85
D85
J86
D86
J87
D87

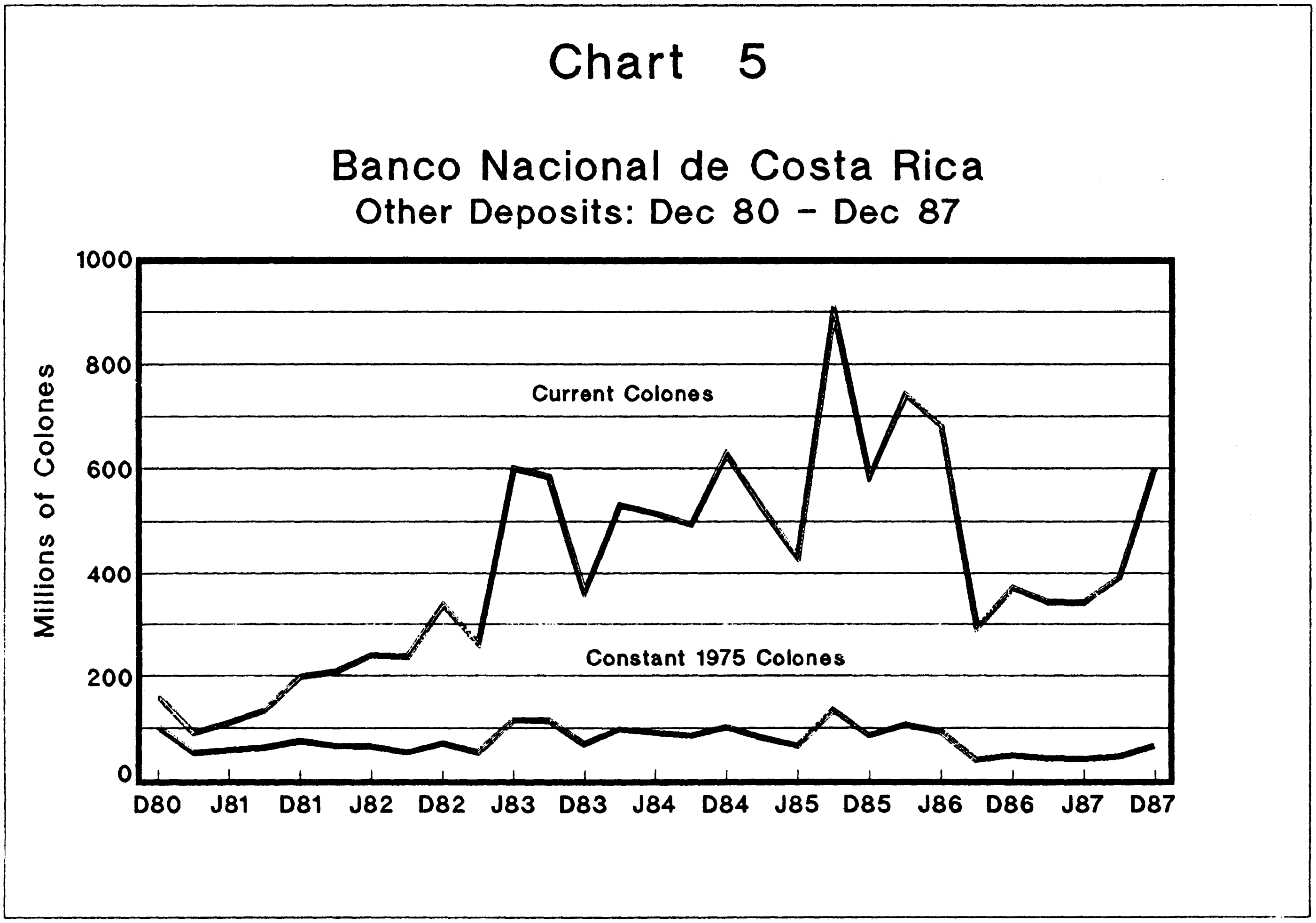


Chart 5
Banco Nacional de Costa Rica
Other Deposits: Dec 80 - Dec 87
Millions of Colones
1000
800
600
400
200
0
Current Colones
Constant 1975 Colones
D80
J81
D81
J82
D82
J83
D83
J84
D84
J85
D85
J86
D86
J87
D87

Chart 6

MARKET SHARE OF TOTAL DEPOSITS
STATE BANKS JUNE 82 - DECEMBER 87

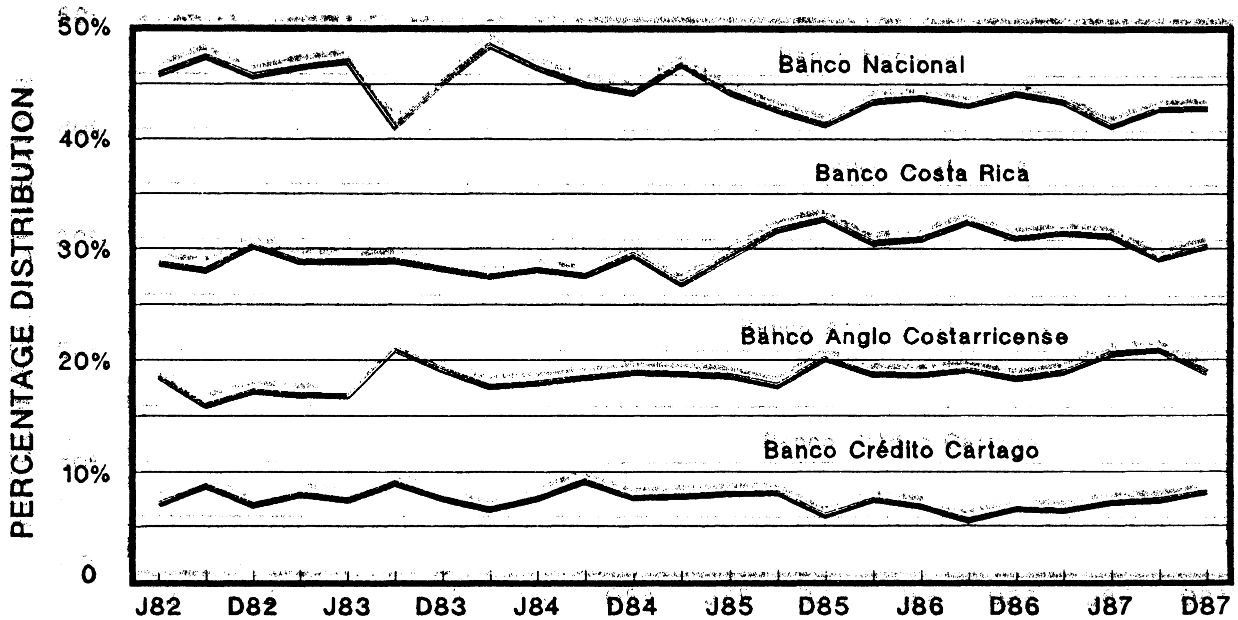


Chart 7

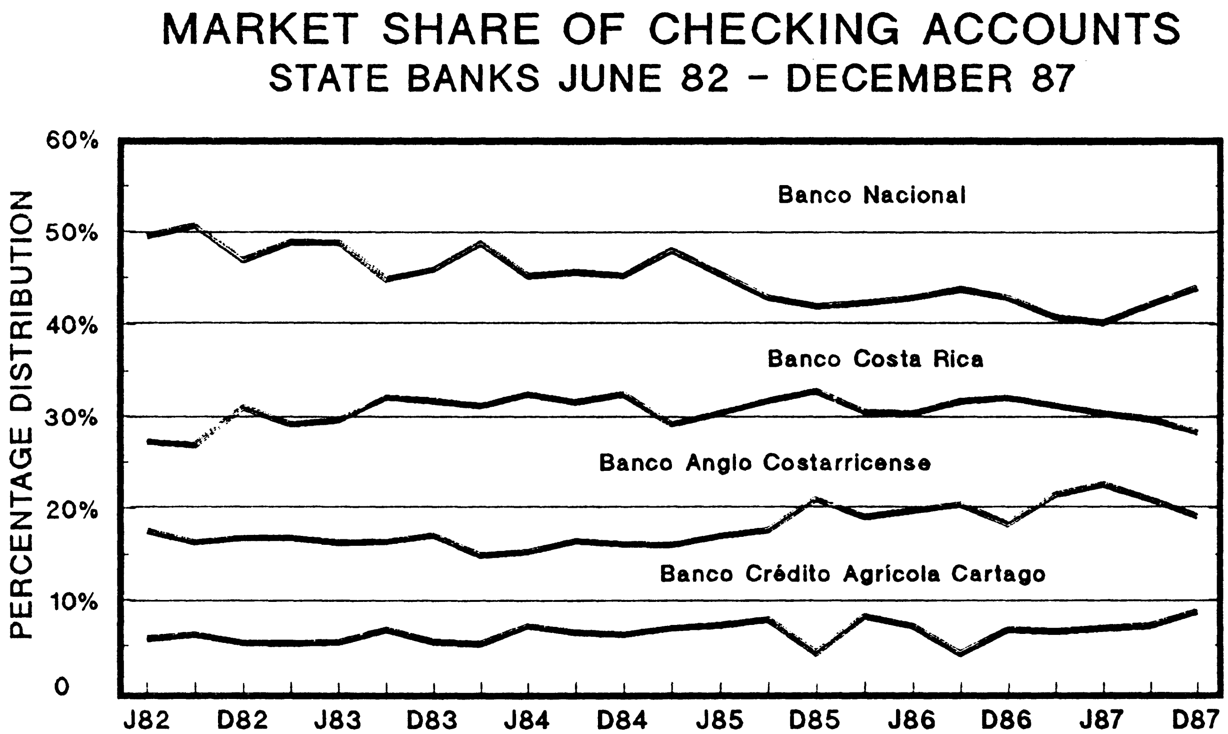

MARKET SHARE OF CHECKING ACCOUNTS
STATE BANKS JUNE 82 - DECEMBER 87
PERCENTAGE DISTRIBUTION
60%
50%
40%
30%
20%
10%
0
Banco Nacional
Banco Costa Rica
Banco Anglo Costarricense
Banco Crédito Agricola Cartago
J82
D82
J83
D83
J84
D84
J85
D85
J86
D86
J87
D87

Chart 8

MARKET SHARE OF TIME DEPOSITS
STATE BANKS JUNE 82 - DECEMBER 87

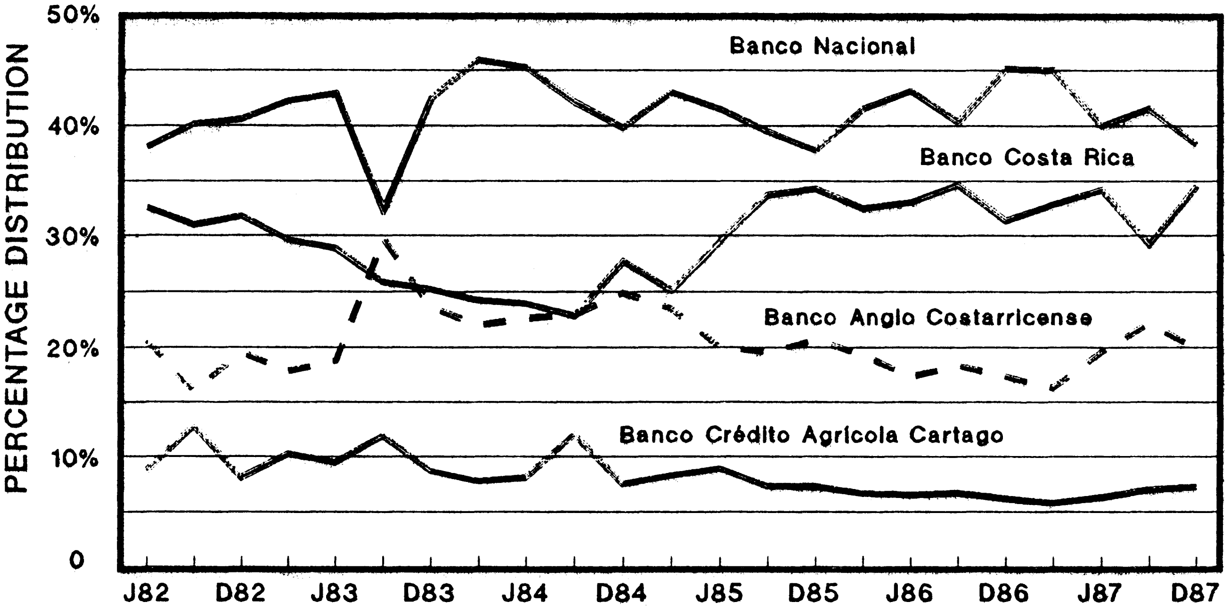
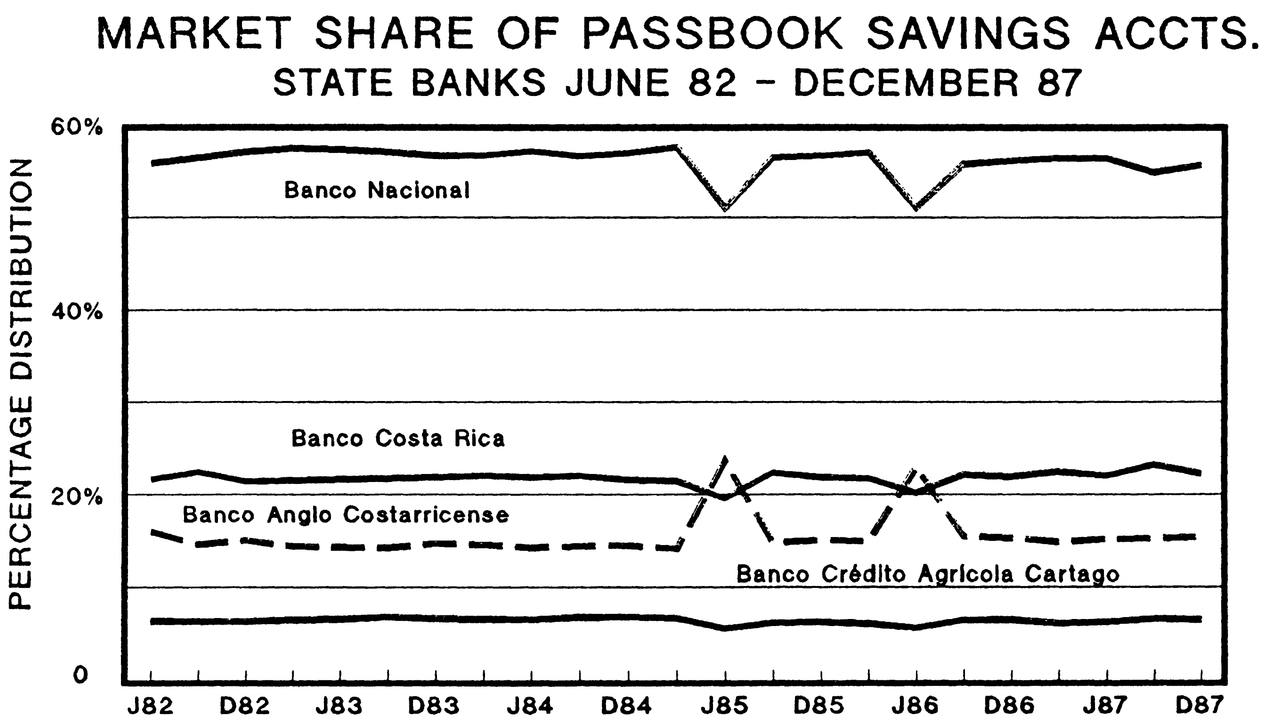


Chart 9


MARKET SHARE OF PASSBOOK SAVINGS ACCTS.
STATE BANKS JUNE 82 - DECEMBER 87
PERCENTAGE DISTRIBUTION
60%
40%
20%
0
Banco Nacional
Banco Costa Rica
Banco Anglo Costarricense
Banco Crédito Agrícola Cartago
J82
D82
J83
D83
J84
D84
J85
D85
J86
D86
J87
D87